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CAN OUR NATIONAL BANKS BE MADE SAFER?

BY THE HON. EDWARD S. LACEY, COMPTROLLER OF THE
CURRENCY.

THE national banking system was organized under an act of Congress passed in 1863, upon the recommendation of the Hon. Salmon P. Chase, then Secretary of the Treasury, who chiefly sought to create a market for bonds of the government and to provide a uniform bank-note currency, national in its character, and amply secured, which would circulate at par in every part of the Union. Two years later (October 2, 1865) 1,513 national banks were in operation, possessing an aggregate capital of \$393,157,206 and \$723,281,252 of deposits. The growth of the system has since been continuous and its success conspicuous. It is worthy of note, however, that the rapid payment of the bonded debt and the consequent high premium commanded by government bonds have rendered the issue of circulating notes upon pledge of these securities unremunerative, so that this feature of the system, so important when inaugurated, is yearly becoming less so. As banks of discount and deposit, however, the associations constituting the national system have become indispensable to the commercial and business interests of the country.

On the 25th day of September, 1891, 3,677 national banks were in operation, having in paid-up capital \$677,426,870, and in surplus and undivided profits \$330,861,160, with deposits aggregating \$2,040,633,924. The system has been in operation for nearly twenty-nine years, and during that period has passed through all the vicissitudes of war and peace, adversity and prosperity. It will be pertinent, therefore, to inquire as to the degree of success achieved, before endeavoring to answer the

question submitted for consideration. On the 31st of last October 4,648 banks had entered the national system, 164 had become insolvent, and 791 had gone into voluntary liquidation, paying their liabilities in full. The failures were equal, numerically, to about $3\frac{1}{2}$ per cent. for a period of twenty-nine years. Of insolvent banks the affairs of 102 had been finally settled, representing \$28,544,992 of proved claims, upon which the creditors have received \$21,172,956, leaving a net loss to depositors of \$7,372,036. The affairs of 62 banks are in process of settlement, representing claims proved to the amount of \$29,247,036, on which has been paid \$17,456,167, leaving assets estimated at \$3,702,925 yet to be distributed, involving a loss to creditors of \$8,087,944. It will be observed that the losses to creditors of national banks during the twenty-nine years of the existence of the system, taking into account the amounts ascertained and the amounts estimated, aggregate \$15,459,980, or an average of \$533,103 per annum. The average amount of the liabilities of all national banks since 1863 approximates \$1,055,434,022, and upon this sum the annual average loss to creditors for the period of twenty-nine years has been only one-twentieth of 1 per cent. The creditors of banks whose affairs have been finally closed have received, on an average, 74.17 per cent., the cost of administration being 9.28 per cent. Of those closed during the last five years the creditors have received, on an average, 90.65 per cent., the attendant expenses being 4.08 per cent.

In considering the security of national banks, as compared with others, we are embarrassed by the fact that official data are not accessible as to banks other than national. The report of Comptroller of the Currency Knox for 1879, however, contains statistics, from partly official sources, showing the failure of 210 State banks during the three years ended January 1, 1879, having liabilities of \$88,440,028, with losses to creditors of \$32,616,661, or an average loss of \$10,872,220 for each of these years. A prominent commercial agency* furnishes a list of 117 institutions, consisting of bankers, brokers, savings-banks, trust companies, and banks other than national, which failed during the year ended June 30, 1891, representing losses to creditors of \$17,477,419, an amount in excess of the total losses of all the banks of the national system for twenty-nine years.

* Bradstreet's.

It is worthy of note that under the National Bank Act we have what is known as free banking, it being competent for any five reputable persons, acting in good faith, to procure a franchise. While this provision is in harmony with our free institutions and is a necessary feature of any enactment calculated to meet the approval of the public, it nevertheless renders it reasonably certain that the management of these associations will sometimes be committed to persons lacking in experience, and occasionally to those wanting in integrity. Again, banks may be organized with a capital of only \$50,000, which facilitates the establishment of associations in places too small to give adequate support, and occasionally tends to promote unhealthy competition. These features may not be conducive to the very highest degree of safety, but they prevent monopoly and enable the general public, even in sparsely-settled regions, to enjoy the advantages afforded by well-conducted banks. The growing popularity of the system is an evidence of its conspicuously faithful service. The annual average accessions during the past five years have numbered 213, which is 53 in excess of the annual average for the entire period since the inauguration of the system. These cover the entire country, new organizations, however, being most numerous in the undeveloped portion west of the Mississippi River. The speculative spirit which has prevailed in that region has not contributed to the safety of these new associations, and the recent reaction has been a potent factor in precipitating the disasters of the year just closed. Nevertheless, the losses recorded above appear inconsiderable when contrasted with the immense volume of business transacted.

In the report of the Comptroller of the Currency for 1891 it is shown that the amount of domestic exchange drawn by all national banks during the year ended June 30 last aggregates \$12,782,212,495. This vast sum represents the transfer of bank credits necessary to simply adjust the balances arising out of trade relations between the various sections of the country. Comptroller Knox in 1881, and the writer again in 1890, procured reports from all national banks, stating their receipts upon given days, so classified as to show the proportion of actual money which entered into their daily transactions. The facts thus elicited, taking the average of two days in 1881 and two days in 1890, show that only 6.94 per cent. of actual money was employed, the

remainder being represented by checks, drafts, and other substitutes for money. It appears, therefore, that of the transactions liquidated through these banks, 93.06 per cent. is accomplished by the use of bank credits. Further use of data thus obtained enables us to make an intelligent estimate as to the magnitude of the business transacted by these associations. It is shown that the receipts of 3,364 national banks on the first day of July, 1890, aggregate \$421,824,726. If we take \$421,000,000 as an average of their daily transactions and multiply this by 307, as the number of business days in the year, it will be found that the total receipts of these banks for a single year aggregate \$129,247,000,000, or a sum greatly in excess of the estimated value of all the real and personal property of Great Britain and the United States combined. If we consider with what economy and safety the immense business thus outlined is transacted, it will be apparent that we have already reached a condition of safety in banking not heretofore realized. The ideal bank is an institution of absolute security. Although the operations of more than a quarter of a century have demonstrated that associations organized under the National Bank Act approximate more nearly than any other to this ideal condition, it may be admitted, without humiliation, that further progress in this direction is attainable. Those whose duty it has been to administer the provisions of the act in question, as they have studied them and watched their application to actual business, have been more and more impressed with the great wisdom of its authors.

In the consideration of measures looking to the greater safety of national banks, it should be borne in mind that 96½ per cent. of these associations have in this respect met the requirements of the most exacting; hence any new restrictions to be imposed should be directed toward preventing loss to the creditors of the remaining 3½ per cent., without imperilling the general success attained. As previously stated, under present conditions no material profit can accrue to national banks by reason of the issue of notes for circulation, and therefore any onerous restrictions might cause many national associations, now successfully and honestly managed, to withdraw from the system and incorporate under the laws of the several States. Similar consideration must be bestowed upon various propositions submitted for greatly increasing the liability of directors for losses which occur under

their management. It is well known that bank directors are not salaried officers and that their services are usually rendered gratuitously ; hence, in the large cities especially, it is with great difficulty that men of high character and great ability are induced to accept these positions, because of the labor involved, the loss of time, and the grave responsibility. Any enactment that would unnecessarily increase the pecuniary responsibility of directors, and place in jeopardy their private fortunes, would no doubt cause the withdrawal from these positions of those most efficient, and cause their places to be filled by men in every way their inferiors, thus aggravating, instead of palliating, the evil resulting from the present lack of attention and efficiency on the part of directors. Certainly no radical innovations should be adopted under the pressure of temporary excitement at the risk of destroying the most effective system of which we have any knowledge.

As a general proposition it may be stated that the success of a bank is dependent upon the integrity and ability of its active officers. Neither legal enactments nor official supervision can create these qualities, although the former serve to deter the wrong-doer and the latter to educate the inexperienced. Whatever, therefore, tends to induce greater care in the selection of these officers by boards of directors will enhance the safety of the system. Experience demonstrates, also, that safety is promoted by a proper distribution of shares. In a general way success is jeopardized where the holdings of capital stock are so widely distributed as to prevent the active supervision of intelligent proprietorship, or so concentrated in the hands of a few as to make possible selfish or corrupt control. Safety ought to be the paramount consideration in bank management. As a rule, this principle is recognized by managers. The exceptions, however, are made so conspicuous by disaster as to give them more prominence than their relative importance warrants. Many dangers menacing these associations are due to mistakes in judgment entirely consistent with complete integrity and the scrupulous observance of legal requirements. Loans are always an accomplished fact before they come to the knowledge of the Comptroller or examiner, and hence serious losses have often become inevitable before official action could be taken. It is obvious that the governmental authorities cannot conduct a banking business,

—they can only inspect and supervise. The National Bank Act is mainly confined, so far as it relates to the transaction of the business of banking, to the imposition of restrictions, leaving the managers of an association free to act within established limits. So long, therefore, as bank officers are deficient in judgment or integrity failures will occur. That system is best which reduces these disasters to the minimum.

In order that we may more intelligently select the remedies to apply, it will be well to consider the prominent causes of failures and their relative importance, as disclosed by an investigation of the affairs of national banks which have heretofore become insolvent. These are stated below in the order of their relative importance, which is indicated by percentages :

1. Depreciation of securities	27.0
2. Injudicious banking	22.7
3. Fraudulent management	18.3
4. Defalcation of officers	9.0
5. Excessive loans to officers and directors	7.1
6. Real estate and real-estate loans	6.8
7. Excessive loans to customers	5.0
8. Failure of large debtors	4.1
	<hr/> 100.0

The classifications adopted are necessarily general in their character, but are sufficiently explicit to facilitate the grouping of certain remedies suggested by experience, and herewith submitted in outline for consideration.

DEPRECIATION OF SECURITIES.

The law should forbid the purchase by national banks of shares of any incorporated company as an investment, and should require the prompt sale of all shares taken to secure doubtful debts. Investments in bonds issued by such corporations should be subject to the same limitations as to amount as may be applied to direct loans to individuals.

INJUDICIOUS BANKING.

Injudicious banking includes, in a general way, such violations of the rules of good banking as do not involve disobedience of law. The remedy rests with the boards of directors, who should exercise greater care in selecting officers, and employ greater diligence in instructing and supervising them.

FRAUDULENT MANAGEMENT.

The presence of fraud taints far too many failures. This indicates the existence of over-confidence on the part of directors and

the necessity of more exhaustive examinations. A proper division of duties, occasional changes of desks among employees, and a systematic and thorough audit of the affairs of the bank by expert accountants of known skill and integrity, will greatly reduce the losses from this cause.

DEFALCATION OF OFFICERS.

Considering the vast sums handled by and the confidence necessarily reposed in bank officers, defalcations are comparatively rare. The severe condemnation visited by the public upon criminality of this character is the best proof of its infrequency. Crime, like disease, is usually insidious in its development, and often exists for years unsuspected. No panacea in such cases can be provided. It is a significant fact that, aside from cases of accidental discovery or voluntary confession, crimes of this character are almost invariably detected by the bank examiner, whose visits are brief and infrequent, and not by the directors, whose continuous supervision is too frequently superficial and perfunctory. The antecedents, habits, associations, and financial necessities of those who handle bank funds must be patiently investigated by directors who would do their whole duty, and severe discrimination enforced against those who fail to meet the most exacting requirements. Only unremitting vigilance and unrelenting prosecution of the guilty can be relied upon to limit an evil that cannot be entirely eradicated.

EXCESSIVE LOANS TO OFFICERS AND DIRECTORS.

Losses from this source may be largely curtailed by the adoption of an amendment to the present law forbidding the active officers or employees from becoming liable, directly or indirectly, to the bank with which they are connected. The liability of directors also should be, by law, made subject to reasonable limitations as to both loans and discounts, inclusive of indorsements and guarantees for the accommodation of others.

REAL ESTATE AND REAL-ESTATE LOANS.

As original loans upon real estate are forbidden by law, and the purchase of real property confined to such as is taken for debt or purchased for use as a banking-house, it seems clear that losses stated under this head result in the main from securities taken as a last resort to secure doubtful debts originally made upon personal security. It is impossible to wholly prevent losses

of this character. In my opinion, however, a limitation should be placed upon the amount which may be lawfully invested in banking-houses, as serious loss and sometimes insolvency result from locking up an undue proportion of the capital in realty, which is thus rendered unavailable at critical periods.

EXCESSIVE LOANS TO CUSTOMERS.

The liability to an association of any person, company, corporation, or firm for money borrowed is now limited by law to one-tenth of the capital paid in. This provision is in the main salutary, as applied to interior banks, but inapplicable to the conditions existing in many reserve cities. Its uniform enforcement is rendered difficult on account of the failure to provide an adequate penalty for its violation. The limitation should be based upon the combined capital and surplus, and made more liberal in reserve cities when applied to loans upon certain lines of first-class securities, including in this category warehouse receipts for staple commodities. This would more fully utilize the very best securities for bank loans and greatly facilitate the periodical movement of farm products so necessary to the general welfare of the entire people. Having properly adjusted these limitations, such reasonable penalty should be provided as would make practicable the uniform enforcement of the law, thereby promoting the safety of the banks and the interests of the general public.

FAILURE OF LARGE DEBTORS.

Under this classification are placed those losses which result from the discount of large lines of commercial and business paper, including bills of exchange drawn against actually existing values, as to which no limitation is now imposed by law. In my opinion, this omission should be supplied, and such bounds put upon transactions of this character as will make imperative a proper distribution of loans and discounts, thus preventing the solvency of a bank from being dependent upon the success or failure of one or more of its chief customers.

Having briefly considered the causes of failure and made such suggestions as seem pertinent, it may be proper to say that the most serious obstacle encountered in all endeavors to promote sound banking has been the inefficiency and inattention of directors. Whatever may be said of the legal aspect of the matter, in the light of recent decisions it is clear that the general

public will continue to hold that power and responsibility are inseparable, and that no director can be morally justified in accepting an office and then utterly neglecting to discharge its duties. While it would undoubtedly be unwise to so increase the responsibility of directors as to render it impracticable to secure or retain the services of those most competent, it is nevertheless due to both stockholders and creditors, as well as to directors themselves, that the duties of the office should be by law clearly defined. Vast interests are intrusted to their care, and commensurate responsibility should rest somewhere. No plan for increasing the safety of our banks which permits directors to abdicate their powers while retaining office, and to avoid the responsibility for losses resulting from disobedience of law by pleading ignorance which could only result from the most persistent neglect, can meet the requirements of the situation.

The supervision exercised by the Bureau of the Currency is of very great value in promoting the safety of national banks. Under its direction the organization of an association is properly completed and the capital actually paid in. It is charged, among other things, with the duty of enforcing those provisions of law which require that loans shall be made upon personal security only ; that a lawful money reserve shall be maintained ; that a surplus fund shall be accumulated ; that dividends shall not be declared until earned ; that the total liabilities of any person, company, corporation, or firm for money borrowed shall not exceed one-tenth part of the capital paid in ; that no association shall make any original loan or discount on the security of the shares of its own capital stock ; that no check be certified in excess of the drawer's deposit ; that reports of condition be made and published at least five times in each year ; that circulating notes be issued and redeemed ; that real estate taken for debt be disposed of within five years from date of acquirement ; that any impairment of capital be made good by assessment upon shareholders ; and that insolvent associations be promptly closed, and their assets converted into money and divided among creditors with diligence and economy. These salutary requirements have the sanction of the highest authority, and the unremitting efforts put forth by the Bureau, through correspondence and otherwise, to insure their enforcement, have largely contributed to the safety for which the system is conspicuous.

In addition to the supervision exercised by means of correspondence, every association is visited at least once in each year by a bank examiner, who has power to make a thorough examination into all its affairs, and, in doing so, to examine any of the officers and agents thereof on oath. He is required to make a full and detailed report of the condition of the association to the Comptroller. This agency is more potent for good than any other at the command of the Comptroller. These examinations have for twenty-nine years been undergoing a process of evolution made necessary by the exigencies of the service, and it is believed that they are to-day more effective than ever before. The ingenuity of unfaithful bank officers is constantly employed in inventing new devices for concealing their unlawful acts. Hence increased vigilance and improved methods are being constantly demanded of examiners. The most valuable service performed by these officers consists in arresting dangerous and unlawful practices at the threshold. The extent to which the safety of the system is due to this timely interposition is, unfortunately, unknown to the general public. It is to be regretted that only failures can be publicly discussed.

So, also, the grave responsibilities devolved upon the Bureau of the Currency are very imperfectly understood. It is charged with the supervision of nearly 4,000 banks, covering a vast area of country in all stages of development. These associations are managed by persons of all grades of ability and experience, and are exposed to dangers of every type and character. In addition to interpreting and administering the law, a vast school of instruction is conducted. Inexperienced managers are instructed; the careless are warned; the indolent aroused, and the unscrupulous restrained. The best and the worst of bank management are daily passed in review, to the end that the good may be commended and the bad reformed. During years of severe business depression, like the one just closed, the financial disasters of a continent are epitomized in its correspondence and reports. The efficiency with which it has met these exigencies can be safely left to the decision of those who intelligently and dispassionately investigate recorded results.

It will be observed that the measures suggested as necessary to a greater degree of safety on the part of our national banks are neither numerous nor radical. The system has long since passed

the experimental stage, and, despite ephemeral and injudicious criticism, it to-day stands firmly established in public confidence, and recognized as indisputably superior to any hitherto known.

In closing it may be said that its safety will be best promoted by adhering with increased fidelity to those sound principles which experience has approved, and which of necessity underlie all true success. To a marked degree these salutary maxims are found embodied in the law governing the national system. Local and exceptional conditions have made minor amendments desirable ; yet, taken all in all, it has proved admirably adapted to the changed conditions developed by the experience of a quarter of a century, and well suited to the wants of the inhabitants of widely-separated States, living under varied social conditions, with customs as dissimilar as climatic and race conditions can produce upon this continent.

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